

Rachel Lomax: Why monetary stability matters to Merseyside

Speech by Ms Rachel Lomax, Deputy Governor of the Bank of England, at the launch of the Merseyside Economic Review 2005, the Mersey Partnership, Liverpool, 24 February 2005.

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It is a great pleasure to be back in Merseyside, as the guest of the Mersey Partnership. It's always inspiring to be in a city that has a great future as well as a glorious past – and I'm not referring to Will Alsop's SuperCity of the North. When I was last in Liverpool everyone was on tenterhooks waiting to hear the outcome of the European Capital of Culture. Congratulations on a spectacular result. By all accounts you're set to be European Capital of shopping too when the new Grosvenor development opens in the Paradise area of the city.

This is my first visit as a member of the Bank of England's Monetary Policy Committee (MPC). Of course, the Bank and Liverpool go back a very long way. Liverpool was a village when the Bank was founded. By the time we opened our first branches around the country, that village had grown into a major port, the gateway to the workshop of the world. So it was natural that the branch the Bank built in Castle Street in around 1850 was one of its grandest, the work of Charles Cockerell. We still have agents in the City – Neil Ashbridge and John Young. And only three years ago the Bank's Court held its annual out-of-London meeting in Liverpool's imposing Town Hall.

I am particularly pleased to launch this, the third edition of the Merseyside Economic Review. The Partnership had its origins in a Daily Post campaign over a decade ago ('who speaks for Merseyside?'). It broke new ground then and it has been breaking new ground ever since. The Economic Review was the first of its kind for any UK City Region. And the Partnership's report on 'the Gender Agenda: Women in the Merseyside economy' is another first.

The value of the Partnership's approach is clear. Economic regeneration is a highly complex long term business which has to bring together many different bodies and initiatives – at local, regional, national, European and even international levels. It's only too easy to lose sight of the big picture. But successful partnership rests on shared goals and clear expectations.

This Review charts the way: it sets out in clear and simple terms what the Partnership is seeking to achieve and it assesses progress against measurable objectives. It has the credibility that comes from being grounded in serious analysis of the issues confronting Merseyside. And it has benefited from the advice of an independent panel of distinguished experts.

There is no doubt that the performance of monetary policy has benefited greatly from setting clear objectives and measuring progress in a transparent and open way. The UK first adopted specific targets for inflation over a decade ago, and at the same time the Bank launched a new quarterly *Inflation Report* to share its thinking about the economic prospect. In 1997, that approach was developed, and its credibility significantly enhanced, when Gordon Brown gave responsibility for setting interest rates to an independent Monetary Policy Committee, consisting of outside experts as well as Bank of England officials.

By any past standards, the period since 1992 has seen a quite remarkable degree of stability, with low and stable inflation and a record period of sustained positive output growth and steadily improving employment. Better monetary policy is not the whole story; but it can share some of the credit for that success.

How does monetary stability like this benefit an area like Merseyside?

The Bank of England's job is to control inflationary pressure in the country as a whole. What we do is set interest rates to keep the total demand in the economy in line with the economy's productive capacity. We don't – and can't – favour any section of the economy, or the country.

Merseyside is a region facing deep seated economic and social challenges, stemming from the decline in its traditional industries. In recent decades, many well paid jobs have gone for ever, and in the new world, earning good money has required a very different set of skills. That kind of change wasn't just a challenge to individuals and their families; it threatened the viability of whole communities.

Low inflation is not in itself a solution to problems like this. But it is a pre condition for solving them. Merseyside had bad luck to be confronted with more economic change in the second half of the twentieth century than most people could cope with at the time. Liverpool never lost its sense of humour, though there were times when it came close to losing its way. Sadly, you can't laugh your way out of economic decline.

High inflation and economic instability fostered the wrong climate for taking the long term decisions that were needed to give Merseyside a new future. The levels of economic inactivity and social deprivation that you are still grappling with today are in part legacies of the 1970s and 1980s, when the sharp ups and downs in inflation, interest rates and national output made it much harder to adapt to structural economic change at the regional level.

But more recent success in delivering low inflation and economic stability has created a much better climate for you to succeed. Economic regeneration can't get off the ground without inspired local leadership, and committed local partnerships. But even with them, it is a long haul to make the investments in infrastructure that modern businesses expect. And so called soft investments – in people, skills, and communities – are even more of a challenge.

Low inflation and low nominal interest rates matter to you because they provide a sound foundation for just this kind of long term planning. And business needs a climate of stability if it is to commit to the investment that's needed to revitalise an area. We know that it is entirely possible to transform old urban areas – there are plenty of inspiring examples from London Docklands to Berlin and Baltimore, and if Liverpoolians ever doubted it, nowadays they need go no further than Albert Dock. But it takes long term commitment.

The key findings in today's Merseyside Economic Review provide convincing evidence that Liverpool has turned the corner– with faster growth in the core city than any other English city and jobs growth more than double the national average. Manufacturing remains important and there is still a strong automotive supply industry, which is high tech these days, but the real growth sectors are tourism, leisure and modern services. Increasingly, for those who acquire the right skills, the jobs are there – a picture that fits with a national labour market where unemployment is now as low as it has been in three decades.

How confident can you be that we will continue to deliver the stability that is our contribution to your future success?

Our latest *Inflation Report*, published last week, paints a favourable picture for the next few years, with continuing steady growth and low inflation. If you trust the MPC to do its job, you might feel reasonably safe in basing your decisions on that outlook. But those of us on the Committee can't afford to take it for granted. So you may be reassured to hear that we spend most of our time worrying about the risks that could throw the UK economy off course; and arguing about how to respond appropriately.

So what are the main risks facing us now?

Last year saw the fastest growth in world output in three decades. We expect growth this year to be less spectacular but still robust. But while the US and China are still expanding strongly, growth has showed signs of faltering in Japan and, to a lesser extent, in our major overseas market, the euro area, and especially Germany. We think this weakness is likely to prove temporary, but we could be disappointed.

Unbalanced growth creates strains. The US has a large current account deficit, which is mirrored by surpluses in the other major trading blocks. The risk is that a better balance will only come about through sharp adjustments in exchange rates and a marked increase in US savings, which may cause a slowdown in global activity.

Closer to home, there is uncertainty about the near term momentum of household spending, by far the largest influence on domestic demand. While it is difficult to be confident about the path of retail sales since the autumn, there is little evidence of much underlying buoyancy. Retail sales are not the whole story, and our central view is that any weakness in consumer spending is likely to be temporary. But we could easily be wrong.

The other key uncertainty concerns the speed with which inflation will pick up. Consumer price inflation remains below the Government's 2% target but there are good reasons to expect it to rise over the next few years. Input cost inflation has risen sharply, and import prices are not falling as much as they were. We think there is very little slack in the economy. The labour market is certainly tight. But the

growth in labour costs has been surprisingly muted, and some cost pressures have been absorbed by lower profit margins. How long can this last?

At present we think inflation is likely to rise above target sometime next year, though we judge the risks to be somewhat on the downside. But it's a difficult call, and our judgement about the balance of risks will be influenced by the way the data shape up in the coming months.

The MPC faces a familiar dilemma, torn between the importance of well grounded analysis and the need to act promptly. On the one hand, there is a case for waiting for more evidence on the issues that underlie these risks – as there almost always is; on the other hand, since interest rates take a year or more to affect the economy, we need to be pre-emptive, to head off trouble at the pass so to speak, even at the risk of sometimes taking the wrong decision.

If we get it right – and a lot of effort goes into ensuring that we do – the outcome of our short term deliberations should be a degree of monetary stability that will create the right climate for you to take the long term decisions on which your economic success depends.